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In this article, Wood debunks 10 tax myths about litigation funding.

Lawyers and clients often need cash, and litigation finance can serve a legitimate role in providing it. Lawyers and clients also may want to lay off some of the risk rather than wait until the bitter end of a case. The litigation finance industry offers nonrecourse money, which is one of its great allures. Lawyers or plaintiffs may seek funding alone or collaborate, with each getting funding. One of the most consistent questions from lawyers and plaintiffs is about the tax treatment of funding. Here are some tax myths about litigation funding.

Myth No. 1: Litigation funding is taxed consistently.

Litigation funding isn't taxed consistently because deals vary. Discussing taxes without the documents is tough, yet plaintiffs and lawyers may ask how their deal will be taxed without handing over a copy of the documents. Financing arrangements and documents vary materially. Is it a nonrecourse loan that has big interest payments? Is it a sale of a portion of the claim or of a portion of the legal fees?

If it's a sale, is it taxed now or only later? Might it even be a partnership between funder and plaintiff? Each of those possibilities may have pluses and minuses, but who will want what? These may sound like simple questions, but they can be difficult, and the answers may be various shades of gray.

Myth No. 2: It's fine to get funding first and worry about taxes later.

Not really. It's true that many plaintiffs and lawyers focus on the dollars and the "interest rate," which may be code for the size of the funder's return. Clearly, the economics of the deal are the biggest driver, but failing to consider taxes upfront can create a real mess later. The plaintiff or lawyer may be enabled by a broker who is shopping funding deals.

But no matter who is on the scene, it is wise to get tax advice before you sign on the dotted line. Funders are unlikely to redo the documents or alter the deal after the electronic signatures are dry. Can you rely on the funder's tax comments? Funders are unlikely to intentionally deceive the lawyers or plaintiffs, but they aren't tax advisers, and they may not be competent to give tax advice, especially not to someone on the other side of a deal. Even so, it is surprising how many lawyers and plaintiffs later say, "But ___ told me this was a nonrecourse loan and that I'd just pay tax at the end!"

Myth No. 3: *Novoselsky* dooms litigation funding.

There has been a lot of fretting about *Novoselsky*,[1] a case in which a lawyer was *taxed* on litigation funding loans. David Novoselsky was a solo lawyer who wrote the funding documents himself, raising \$1.4 million with his "litigation

[1] *Novoselsky v. Commissioner*, T.C. Memo. 2020-68.

support agreements." The IRS and Tax Court said they weren't loans, so the proceeds were all taxable upfront as advance payments of his fees.

Notably, all of Novoselsky's "lenders" had a preexisting financial stake in the litigation. Does this case jeopardize real litigation funding? It's hard to see how. In a commercial litigation funding transaction, the funder has no preexisting interest in the litigation. That should make it difficult for the IRS to argue that the funder's advance is a payment for the attorney's services.

As long as the loan documentation doesn't condition the borrower's obligation on the outcome of the litigation, *Novoselsky* shouldn't prevent loans from qualifying as loans, or as purchases in deals structured that way. But isn't every nonrecourse loan conditional? Not really. There is a big (tax) difference between a contingent note and an absolute note that is enforceable only against specific collateral.

Novoselsky is a grim reminder that plaintiffs and lawyers shouldn't prepare their own funding documents. They shouldn't include language saying that their legal obligation to repay a loan depends on the success of the litigation. The obligation should be absolute, but it's fine to limit the funders' recourse to a security interest in the litigation proceeds.

Besides, loans are uncommon in commercial litigation funding. Most are purchases, often prepaid forward purchases. In the few loans that come along, professional loan documentation should include a noncontingent payment obligation. And that defangs *Novoselsky.*

Myth No. 4: *Novoselsky* dooms lawyer funding.

No again. *Novoselsky* warns lawyers not to borrow from clients or anyone else with a stake in the case's outcome. Otherwise, the "funding" just looks like an advance payment of legal fees. But if the funding is structured as a loan and is a real loan that the lawyer is legally obligated to repay, it simply isn't taxable. Lawyers do bank loans all the time, and those are hardly at risk. Of course, most funding deals aren't structured as loans, and many are prepaid forward agreements.

It's true that lawyer funding deals may be more vulnerable to IRS attack than plaintiff funding deals. After all, the lawyer will only be collecting ordinary income no matter what, whenever the proceeds come in. It may be subject to self-employment tax too. A plaintiff selling a piece of a case may well have capital gain.[2] Also, there is the tax basis question.

The lawyer is best positioned to argue that he can sell a piece of one or more cases under a prepaid forward contract without having to pay current tax on the upfront cash if she has been capitalizing costs of the case. That way, the lawyer really cannot compute gain or loss on the contract until the case concludes. In any event, the properly structured commercial funding transaction by a lawyer for a case or a portfolio of cases is still alive and well after *Novoselsky.*

Myth No. 5: You can always avoid tax on legal fees.

Legal fees can be taxed in surprising ways, especially under the Tax Cuts and Jobs Act, which affects 2018 and later tax years. Most plaintiffs assume that if they have a contingent fee lawyer, the worst tax result they will ever face is having their entire *net* recovery (after legal fees) taxed to them as ordinary income. However, the plaintiff in a contingent fee case is usually treated as receiving 100 percent of the recovery, even if 40 percent or more is separately paid to the plaintiff's attorney. The Supreme Court so ruled in *Banks* in 2005.[3]

Most plaintiffs assume that they can just deduct the legal fees, which would make it a wash. But in 2018 and later tax years, some plaintiffs may have no deduction for legal fees.[4] Some argue that the fees are statutory or court awarded,[5] and some claim they are allowed an above-the-line deduction, even if their case isn't classically an employment or civil rights suit of the sort described in section 62(a)(20).[6] In any event, the increased worry about the tax treatment of legal fees can complicate taxes on litigation funding, particularly since the client may face a

[2] *See* Robert W. Wood and Jonathan Van Loo, "Investing in Lawsuits: The Plight of the Plaintiff," *Tax Notes*, May 5, 2014, p. 613.

[3] *Commissioner v. Banks*, 543 U.S. 426, 430 (2005).

[4] *See* section 67(g) (disallowing all miscellaneous itemized deductions through 2025).

[5] *See* Wood, "Lemon Law Plaintiffs Face Tax Lemons on Legal Fees," *Tax Notes Federal*, Jan. 13, 2020, p. 265.

[6] *See* Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements," *Tax Notes Federal*, Mar. 2, 2020, p. 1481.

tax impact even if the lawyer alone is getting funding.

Myth No. 6: All funders make nonrecourse loans.

To most plaintiffs, what is most important is that the money is nonrecourse. That may lead to a kind of shorthand, emphasizing the nonrecourse part more than the loan part. The second biggest priority for plaintiffs is that the upfront money from the litigation funder won't be taxed when received.

Why have your upfront money nearly halved by taxes if you can avoid it? With a loan, you receive loan proceeds, which aren't taxable because you must repay the lender.[7] A loan defers any tax on the receipt of the initial funding. It's easier to document, and some lawyers and clients prefer it. However, there can be tax downsides later.

Besides, funding documents written as loans are increasingly rare because of the funder's own issues, tax and nontax. Many litigation financing documents are written as sales, although some funders also shy away from using that term.[8] Some refer to them simply as "investments." Sales are taxable, so the normal rule would be that the lawyer or client must pay tax in the year the funder provides the upfront cash.

Getting money that will be immediately cut in half by taxes is very different from getting loan money that you can fully deploy without taxes. Running some numbers and thinking about timing in competing loan and sale scenarios can be helpful.

Myth No. 7: Prepaid forward contracts all use the same form.

Does the title of the agreement tell you what it is, for tax purposes? Hardly. A label doesn't mean much, especially when it comes to tax law. When the parties opt for a sale, funders often document their investment as prepaid forward contracts. Because the transaction is a sale, you might assume you have to report the upfront money (the sale proceeds) immediately as income.

However, this is a sale contract that leaves open how much of the case proceeds the seller will have to deliver to the funder. The amount is uncertain because the formula for the seller's payment generally depends on facts that won't be known until the case concludes. The contract calls for a future sale, but the sale doesn't close until the case is resolved. In the meantime, your receipt of the funder's upfront cash is treated like a tax-free deposit.[9]

To provide that kind of deferral, a prepaid forward contract should have elements specified by the IRS. The details are listed in Rev. Rul. 2003-7, 2003-1 C.B. 363. If you qualify, you generally shouldn't have to report as income the upfront payment until the conclusion of the case. However, good documentation is critical. You don't want to receive taxable money, pay a litigation finance company a steep return, and find that you cannot deduct or offset a big payment to the funder against your recovery.

Does your deal track the Rev. Rul. 2003-7 requirements? What if a plaintiff sells a share of his future recovery for a fixed sum of money, and the funder is entitled to receive 50 percent of all money the plaintiff receives by judgment or a settlement? Would it matter if instead of receiving 50 percent of all proceeds, the funder is entitled to all its money back first, and then 30 percent of anything that exceeds that?

What if instead of some kind of sharing arrangement, the funder purchases 100 percent of the case proceeds? The parties may be thinking largely about the economics, but the tax treatment can also depend on these details. Timing is also relevant. The funding may come while the case is on appeal or when the judgment is final. What if all the money from the funder doesn't come at once? Does it matter if, in addition to the upfront payment, the funder will fund expenses incurred as the litigation progresses?

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[7] *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983).

[8] Most funders go out of their way to disclaim any sort of control of the plaintiff's case or any ownership interest in the plaintiff's underlying claims. Instead, they insist that they are purchasing no more than a share of the future proceeds of the litigation. In recent years, there has been a tendency for funders to avoid using the terms "purchase" and "sale" to describe how they have acquired even that watered-down interest. In some cases, the funder's documents don't characterize the transaction beyond stating that is *not* a loan and does *not* create a partnership.

[9] *See* Wood, "Prepaid Forward Contracts Aren't All Bad," *Tax Notes*, Apr. 16, 2012, p. 365.

Those questions are meant to show that there is no one-size-fits-all transaction document or tax treatment. The recipient varies too. Plaintiffs may be the most likely parties to seek funding, but lawyers increasingly do it too. A lawyer may "sell" part of his interest in a particular case, or even in a portfolio of cases. If the contract covers a portfolio of 10 cases, can the lawyer defer paying tax on any of them until the proceeds of the final case are received?

If the results of each sale must be reported separately, how does the lawyer determine profit or loss if the contract fails to allocate the upfront cash among the 10 cases? Plaintiffs and lawyers hungry for upfront cash may not work through all these issues until later, but planning ahead is helpful. There may be some element of guesswork involved, but knowing the tax odds before you sign the deal might save you from a difficult time later.

Myth No. 8: Litigation funders make high-interest loans.

Funders usually don't want loans, which generate interest taxed as ordinary income. Plus, if the funder has offshore investors, they don't want to be in the lending business. That generates income effectively connected with a U.S. trade or business, which would make the foreign investor's income taxable in the United States and require a U.S. tax return.

Funders want to make a purchase or investment, especially if they can get capital gain treatment.[10] That makes everyone happy: U.S. investors who pay taxes, non-U.S. investors, and even U.S. tax-exempt investors. Capital gain requires a capital asset and a sale or exchange.[11] Funders frequently cite section 1234A, which permits sale or exchange treatment even when there hasn't been a regular sale or exchange.

Some funders take the position that the payments they receive are paid to terminate their rights to a share of the proceeds under the litigation funding contract. The limited guidance from the IRS suggests that the agency may take a dim view of this argument,[12] but the question may have to be decided by the courts.

Myth No. 9: Funders don't worry about non-U.S. investors.

Foreign persons want access to U.S. capital markets, but without having to pay U.S. taxes if they make money. They invest heavily in the United States, including in litigation funding, yet they don't want income effectively connected with the conduct of a U.S. trade or business. Effectively connected income is a term of art, and it is usually a bad thing that funders want to avoid.

If the funder has ECI, its non-U.S. investors, who typically participate as limited partners, may be required to file U.S. tax returns and pay tax on their shares of income at the same rates as U.S residents.[13] That is the last thing non-U.S. investors want. Does litigation funding rise to the level of a U.S. trade or business (like some lending operations)? Or is it more like equity investing, which can usually be conducted from a safe distance offshore?[14]

The facts of the investment are relevant, as is what the funder actually does in the United States. Even if the non-U.S. investor is able to steer clear of the ECI taint, nonbusiness income can also be taxed by the United States if it is fixed or determinable annual or periodic income (FDAP).[15] Non-U.S. investors who receive FDAP don't have to file U.S. tax returns, but amounts paid to them are subject to up to 30 percent U.S. withholding tax. Fortunately, some tax treaties reduce the withholding rate to 5 percent or 10 percent.

[10] *See* Wood and James L. Kresse, "Is Litigation Finance Tax Treatment in Jeopardy?" *Tax Notes*, Mar. 7, 2016, p. 1193.

[11] *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941).

[12] *See* FAA 20154701F (contending that a funder's profit when it received case proceeds was not "gain" for purposes of section 1234A because there had been no "sale or disposition" described in Section 1001). *See* Wood and Kresse, *supra* note 10.

[13] *See* section 871(b) (nonresident alien individuals); and section 882(b) (corporations). A non-U.S. person investing in a partnership that conducts a U.S. trade or business is treated as engaged in that U.S. trade or business. Section 875(1).

[14] Even non-U.S. persons who actively trade stocks, securities, or commodities in the United States can avoid having a U.S. trade or business if they trade through a resident broker, commission agent, custodian, or other independent agent and abstain from having an office in the United States that directs or effects the trades. *See* section 864(b)(2)(A)(i), (B)(i), and (C).

[15] *See* sections 871(a)(1) (nonresident alien individuals) and 881(a) (corporations).

A non-U.S. investor's capital gains, on the other hand, are typically neither ECI nor FDAP.[16] They are simply ignored for U.S. tax purposes. Therefore, the promise of capital gain is even more alluring to non-U.S. investors. A U.S. investor in a litigation funder monitors the rate spread between capital gain and ordinary income, but the stakes for non-U.S. investors are even bigger.

Myth No. 10: Tax-exempt investors don't pay any tax.

Like foreign investors, tax-exempt investors also invest in litigation funding. It is true that tax-exempt organizations generally don't pay federal income taxes. However, income earned from an unrelated trade or business can be taxed.[17] Unrelated means a business that doesn't relate to an organization's tax-exempt mission. Unrelated business taxable income is taxable at the corporate rate.

Tax-exempt organizations wonder whether litigation funding might be treated as a trade or business. If it is, all is not lost. They can still hope that their profits can be treated as capital gain, which generally isn't treated as UBTI under section 512(b)(4).

Conclusion

Litigation funding isn't primarily about taxes, but it is surprising how pivotal taxes can be. Taxes matter to lawyers, plaintiffs, funders, and the entire range of investors in funders. Yet, surprisingly, even relatively sophisticated lawyers and clients seem to assume that all funding is taxed the same. It's a nonrecourse loan, right? Assumptions can be dangerous.

Seeing a term sheet and set of definitive documents is key due diligence. Plaintiffs nearly always want to delay taxes until later. And that usually means either a loan or a prepaid forward contract. Some funders are willing to change their basic forms of contract a little, and some may change them a lot — especially if they really want a specific investment.

Funders must also deal with their investors — domestic, foreign, and tax exempt. That can make for a complex web of tax issues that need to be considered, often from multiple points of view. A big payday at the end of a case can be good for everyone, even if you have to file tax returns and pay taxes. But it's wise to try to handicap the tax treatment upfront before the funding documents are signed so you don't find yourself trying a Hail Mary pass at tax return time. ■

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[16] Under section 865(a), income from a nonresident's sale of personal property is generally treated as income from sources outside the United States.

[17] *See* section 512.